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Confédération Européenne des Associations d'Administrateurs
European Confederation of Directors' Associations

Ethics of directors and managers:
a key issue for corporate governance

The following paper is a discussion paper raising qome of the issues concerning ethics and corporate governance which will be discussed during the conference organised by ecoDa on the occasion of its first annual meeting. As a confederation of directors' associations, ecoDa is concerned with any subject relative to directors' functions and the problems they may face regarding their own position as well as the functioning of their firm.

Among those, ethics has gained growing importance during the past few years. As a matter of fact, one may wonder if the question has to be asked whether ethics pay or not. Is it a question of whether it pays and why and how much it should pay?

However, directors are ultimately responsible for misconduct both within the firm and of course within the Board itself.

For a long time, ethics has appeared to belong to the field of philosophy rather than business. This time is clearly over now. Events in recent years have shown how important the way they tackle ethical issues is for firms and what the role of the Board is in this field.

Yet ethics is much easier in theory than in practice. It is difficult enough to set any framework for universal principles of ethics applicable to any country or any even firm, let alone to develop these across national boundaries and legal systems and cultures.

Most governance principles are not of legislative nature but rest upon behaviour. Progressive development and implementation of this "soft law" is the route ecoDa favours.

Ethics as a starting point for good governance

Some history about governance theories

The first studies about corporate governance are now more than 70 years old. They were born in the United States in the context of the crisis of the 1930s, when it became clear that a large difference now existed between ownership an the management of large firms.

For a long while, corporate governance has been seen as the way the owners of the firm could control it, overseeing management to ensure the firm's business is conducted in a way maximising the return on investment and protecting shareholders' assets.

At the same time, given the rising size of some multinational firms and the development of global businesses, it became clear that their main decisions were having important consequences far beyond the firm and its shareholders – that is, on their employees, clients, communities, the environment, etc... There was a growing lobby for stakeholders to be considered.

This debate went on in the 60s and the 70s, and indeed it is still open. What has changed is the economic context with the growing importance of financial criteria and short term analysis on one hand, and of the media and public opinion on the other hand.

However, it now seems widely accepted that stakeholders' interests are part of the debate and their interests have to be considered if the firm is to prosper in a long term perspective.

How ethics became a key issue for corporate governance

If globalization and the development of new technologies have offered firms wide opportunities for development, they have also shown, during recent years, how misconduct – whether systemic or of one single employee like in the case of the Barings Banks – can threaten the mere existence of a firm.

The ever quicker transfer of information enabled by new technologies and media have also played their part in the recent rise of ethical issues, resulting in an obligation for firms to ensure rules are correctly defined and applied. The case of the Enron Corporation will stay as a remarkable example of how useless are rules when unethical attitudes are deliberate at the top of the firm.

Thus the reputation risk – and ethical issue as a whole – is now a key issue for a growing number of firms.

Does this mean it is correctly addressed?

Value-based ethics versus rule-based ethics?

An apparently simple word (êthikos – how to behave)

Ethics seems to be a fairly simple word as long as one does not try to give it a universal meaning. Its etymology itself is simple: it is the knowledge of the right way to behave.

Of course the problem begins here.

…but a prodigious word: we talk about the "ethics" of a wide variety of things.

We talk about the ethics of a wide range of human activities, sometimes as if the principles guiding one's actions depend upon which profession one is involved in. As a matter of fact, each profession has its own set of rules, derived both from commonly accepted principles and the proper needs and organization of each profession. The same factors apply to the ethics of the firm.

Thus a distinction has sometimes been made between value-based ethics and rule-based ethics.

Value-based ethics or rule-based ethics?

- Value-based ethics refers to a supposed set of principles applicable to a wide variety of situations.

Value-based ethics is beyond any particular rule applying to a definite profession. It addresses what *should* really be done.

- Rule-based ethics refers to deontology – that is a set of professional rules, applicable for instance to directors.
Rule-based ethics refers to the application of a definite professional code of conduct at each level from the top to the base of the company – implicitly, codes of conduct directly or indirectly rest upon what *should not* be done.

Thus it seems that differentiating between positive and negative commitments is a key issue in this debate.

What about directors?

It is now becoming ever more widely accepted that both positive and negative commitments apply to them. As a result, no single set of rules will in itself encompass a director's obligation.

Measuring Ethics?

Measuring the enforcement and the result of ethical attitudes is particularly difficult.

Inside the firm: how to promote "ethical behaviours"?

Directors bear a particular responsibility when it comes to ethics:

- how can one ensure that the Board itself and each of its members, as an individual, acts ethically?
- how can the board develop and promote ethical principles for the firm, the people within it and its dealing with outsiders?
- How can the board get reasonable assurance that ethical principles are applied in the firm at every level of the hierarchy – notably with regards to employees?

Outside the firm: what makes your firm be "ethical"?

Outside the firm, does it only look ethical, sound ethical, or can the Board be certain that it is not mere appearance and that the firm is not at risk ?

Some practical issues

Whatever the Board's position is with regard to ethical issues, a number of issues cannot be avoided? Let us take a few examples.

Where is your firm doing business

Large firms are more and more involved in the development of emerging countries - and sometimes under-developed countries – the ethical issues associated with conducting business in these locations have to be addressed by the directors.

Which criteria should be used when deciding about a new location?
Which local ways are acceptable or not?
Etc…

Wages and compensations

Does the firm pay attention to its policy regarding salaries and compensations?
Over recent years, the gap has been growing between the highest and the lowest paid within the firm. What are acceptable differentiations?

Conflict of interests

Eliminating all potential conflicts of interests, whether it is inside the board or the management or at various levels of decision-making is merely impossible.

The important question is how the firm addresses this:
- first, do the Board and the management openly acknowledge the existence of that type of issue?
- second, are these cases explicitly discussed?
- third, are directors and the management ready to solve the problems at the moment when they arise?

Insider trading

How to detect and prevent insider trading at a time when both the complexity of large firms and the sophistication of technologies seem to make it ever easier? Moreover, where does insider trading begin?

Whistle blowing

Whistle blowing is an issue that cannot be escaped. And it is all the more difficult to solve as national or local cultures will make the answer differ widely from one place to another.
The American culture and the European one, for instance will result, in many cases, in different answers to the same question.

Those are a only a few subjects involving ethical choices. There are many more.

As a consequence, there is certainly no other way, for directors concerned with ethics, than to address this issue directly at the firm's level before accepting any position in the Board, so as to check if he feels the firm's positions are in line with his own, and to ensure that it is regularly considered by every board on which he/she sits.

A few questions for corporate directors

One essential question is whether the Board is convinced of the company's need to manage corporate ethics. Another is whether it really develops strategies to raise the ethical standard of the organization and build trust and management of reputation as a competitive advantage. These questions go far beyond the mere question of the functioning of the board. Not only are the directors concerned in their day to day activity, but the whole company, including owners, management and employees.

As a result, the following questions should be asked by any director:

- Does the company really manage ethics and how?

    Does the Board lead and support management in this field?

Does the company have a defined approach to ethics?
Does it fit into its overall values and strategy?
Is ethics management discussed by the board, when and how regularly?

- Is there a clear identification of responsibilities for ethics?

- What are the means designed to solve ethical difficulties?

Is there any guidance to employees facing possible ethical dilemmas?
What is the position of the company regarding “whistleblowers”? Are they protected?

- Is the company ready to assume negative impacts on its results?

Whereas it might be reasonably assessed that ethical concern should have a positive impact in the long run for the company, which attitude does it adopt, and especially its board of directors, if there are negative impacts in the short term ?

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